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The Altered Landscape of Special Needs Planning

BY SHANNON MCNULTY
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Two of the most important pieces of federal legislation enacted in recent years—the American Taxpayer Relief Act (ATRA) and the Patient Protection and Affordable Care Act (ACA)—have dramatically impacted estate planning for those who care for a loved one with special needs. While each law has a separate and significant effect on this area, together they call for no less than a fundamental change in the way we design solutions for these clients.

Planning for a beneficiary with special needs almost always involves the implementation of a supplemental or special needs trust (SNT), the administration of which requires an inexact balancing of several factors: establishing or maintaining eligibility for government benefits; maximizing the beneficiary's quality of life; granting the beneficiary the appropriate level of financial control; protecting assets from creditors; and minimizing income and estate taxes. Due to a historical lack of health care options for beneficiaries other than Medicaid enrollment, maintaining the beneficiary's eligibility for this program is often a primary goal of the SNT.

While the SNT will continue to serve as the centerpiece of special needs planning, the ATRA and the ACA have significantly altered the cost-benefit analysis of SNTs as they are currently administered. The ACA has provided certain disabled and chronically ill people with alternatives to needs-based government health care. Meanwhile, the tax provisions of the ATRA and the ACA have dramatically increased the tax burden on SNTs. Together, these changes increase the cost of maintaining an SNT, while at the same time reducing the value of its benefits.

ACA EXPANDS OPTIONS

Prior to 2014, health insurance companies could, and often did, refuse to insure applicants who suffered from pre-existing medical conditions. Even if coverage was available, the cost was generally prohibitive or the policy imposed unacceptable limitations on coverage. As a result, those who suffered from a disability or chronic illness were forced to rely on government-provided health care, in most cases in the form of Medicaid.

Traditional Medicaid imposes strict asset and income limitations; enrollment is available only to people with less than approximately $2,000 in monetary assets and income below the federal poverty line. In order for a disabled person to receive Medicaid, he or she is often deliberately impoverished, notwithstanding the family's financial resources or the person's ability to responsibly manage his or her own finances.

SHANNON MCNULTY *is a trusts and estates practitioner in Philadelphia whose practice focuses on asset protection and sophisticated income and estate tax strategies. Learn more about her firm at www.mcnultytaxlaw.com*

Parents leaving money to a disabled minor or adult child as part of an inheritance are advised to leave it to an SNT, so as not to disqualify the child from Medicaid eligibility. Trustees carefully administer SNTs so as not to provide the beneficiary with assets exceeding the Medicaid asset limitations. In order to protect the beneficiary's eligibility for Medicaid, SNTs must comply with extremely strict distribution standards. Such restrictions can severely limit the independence and privacy of the beneficiary and create a substantial administrative burden. The beneficiary is required to submit a request to the trustee for almost every imaginable expense, from household cleaning supplies to magazines. While by no means an optimal situation, such measures have been accepted as the cost of maintaining health care coverage for a person with a disability or chronic illness.

The ACA has dramatically changed the health care environment for people with disabilities or chronic illnesses, potentially altering the traditional SNT model. The ACA requires private insurance companies to offer health care policies to people with pre-existing conditions on the same terms as the rest of the population. Those policies must include certain essential benefits and cannot include lifetime coverage limitations. Additionally, the ACA encourages states to expand Medicaid to residents whose income is at or below 133 percent of the federal poverty level, regardless of the value of their assets. Medicaid expansion coverage by the states need not provide benefits equal to traditional Medicaid, but it must provide the same essential benefits as those required for private policies. The benefits provided by traditional Medicaid remain the same for those who satisfy the income and asset limitation.

As a result of these changes, people with disabilities and their families have far more health care options than they had previously. Depending on the family's finances and the severity of the person's disability, forgoing the financial restrictions of traditional Medicaid for the private health insurance market may be an attractive option. Pennsylvania has not accepted the Medicaid expansion funds from the federal government, so that option is not available to date. However, it is likely the state will eventually implement the expansion in some form.

HIGHER TAX RATES

SNTs established by a third party (such as a parent) are generally either created or funded at the death of the grantor. As a result, this type of SNT is taxed as a complex trust; income earned from trust assets and retained in the trust is taxed to the trust itself, and distributions of trust income are generally taxed to the recipient beneficiary. Because complex trusts are subject to compressed income-tax brackets, income that is taxed to a trust is generally subject to higher tax rates than if the income were taxed to an individual. The increased marginal income tax rates and increased tax rates on certain capital gains imposed by the ATRA, together with the net investment income tax levied by the ACA, have significantly increased the tax burden on income generated by complex trusts.

For example, with respect to an individual taxpayer, the highest marginal income tax rate of 39.6 percent applies only to income in excess of about $400,000. On the other hand, trust income exceeding just $12,150 (for 2014) is subject to the 39.6 percent rate. Trust income exceeding the $12,150 threshold is also subject to the 20 percent tax on dividends and capital gains and the 3.8 percent surtax on net investment income.

In many trusts, the high income-tax rates can be avoided by distributing trust income to the beneficiaries, which is then taxed to the beneficiary instead of the trust. With special needs trusts, however, distributing money to the beneficiary can result in a loss of Supplemental Security income or Medicaid, so it is common for income to accumulate inside the trust, potentially resulting in significant tax liability.

COST-BENEFIT ANALYSIS OF SPECIAL NEEDS TRUSTS

Due to the ATRA and the ACA, special needs planning has become far more nuanced than it has been in recent decades. Whereas SNTs were traditionally administered with a goal of maintaining eligibility for traditional Medicaid, that goal should now be balanced against other factors.

Maintaining a beneficiary's eligibility for traditional Medicaid is no easy task. Due to Medicaid's strict income and asset limitations, distributions from an SNT are seldom made in the form of cash and require a detailed record. The beneficiary's assets and income must be carefully monitored so as not to exceed the Medicaid eligibility thresholds. As a result of these restrictions, the beneficiary's independence and quality of life can suffer tremendously.

With other health care options available, it is now necessary to make a more careful assessment of whether relying on traditional Medicaid is the best option for the beneficiary. Enrolling in either the private health care exchange or in the new Medicaid expansion coverage would eliminate the beneficiary's need to comply with cumbersome asset limitations imposed by traditional Medicaid. If appropriate, this would allow a beneficiary with a noncognitive disability to manage his or her own money on a day-to-day basis and enjoy a more normal lifestyle.

For families with modest means or where the disability is particularly severe, ensuring Medicaid eligibility will likely continue to be a primary goal. Medicaid provides more extensive coverage for skilled nursing care, medical equipment, and assistance with daily tasks than insurance offered in the private market.

On the other hand, where the family has substantial financial resources and the beneficiary is capable of performing daily tasks and managing his or her daily finances, a solution that does not require Medicaid eligibility may be preferable. In addition to promoting the independence and quality of life of the beneficiary, a looser trust standard may produce tax savings as a result of income being taxed to the beneficiary instead of the trust. In certain cases, tax savings may outweigh the financial benefit of receiving Medicaid.

CONCLUSION

Both the ATRA and the ACA have dramatically changed the landscape of special needs planning. Strict administration of an SNT in order to qualify the beneficiary for Medicaid may not be the optimal solution in every special needs case. In the wake of these legislative changes, planners should reassess whether a strictly administered SNT is appropriate for a disabled client or beneficiary on a case-by-case basis. Now more than ever, SNTs should be drafted to allow a trustee to override strict standards intended to qualify the beneficiary for means-tested government programs. On the other hand, current trustees of SNTs should revisit whether compliance with strict distribution standards is in the best interest of the beneficiary. •